APPEALS
INDUSTRY SPECIALIZATION PROGRAM
COORDINATED ISSUE PAPER

INDUSTRY: Partnership

ISSUE: Subchapter K Anti-abuse Rule

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EFFECTIVE DATE: SEP 23 1998

SETTLEMENT GUIDELINE

SUBCHAPTER K ANTI-ABUSE RULE
REGULATION § 1.701-2

SEP 23 1998

EFFECTIVE DATE: __________

STATEMENT OF ISSUES

Issue 1. Under what circumstances is the Commissioner of the Internal Revenue authorized under Treas. Reg. § 1.701-2 to recast a transaction involving the use of a partnership?

Issue 2.* Whether adjustments made because of the partnership anti-abuse regulation, Treas. Reg. § 1.701-2, are partnership items under I.R.C. § 6231(a).

* Issue 2 is not a coordinated issue. It is included as a supplement to the coordinated issue.

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SETTLEMENT GUIDELINE
SUBCHAPTER K ANTI-ABUSE RULE
REGULATION § 1.701-2

CONCISE GENERAL STATEMENT

ISSUE: PARTNERSHIP ANTI-ABUSE RULE

INDUSTRY: PARTNERSHIP

Under what circumstances is the Commissioner of Internal Revenue authorized under Treasury Regulation § 1.701-2 to recast a transaction involving the use of a partnership?

In response to perceived abuses achieved by structuring transactions through partnerships, the Commissioner issued Treasury Regulation § 1.701-2. The regulation declares that the Commissioner has the authority to recast transactions to ensure that the income tax treatment of each partnership transaction is consistent with the intent of subchapter K of the Internal Revenue Code.

The determination of whether a partnership transaction may be recast is based on facts and circumstances. Factors to consider include the purpose of the transaction, the aggregate tax liability of all the partners, and the intent of subchapter K.

Examination's position is that the Commissioner is authorized to recast abusive partnership transactions.

The settlement guideline discusses the factors to consider when negotiating a settlement of the issue. The guideline also explains why, in the case of a TEFRA partnership, any adjustments under the regulation should be made as partnership items under I.R.C. § 6231(a).

SETTLEMENT GUIDELINE
SUBCHAPTER K ANTI-ABUSE RULE
REGULATION § 1.701-2

STATEMENT OF ISSUES

Issue 1. Under what circumstances is the Commissioner of the Internal Revenue authorized under Treas. Reg. § 1.701-2 to recast a transaction involving the use of a partnership?

Issue 2. [*] Whether adjustments made because of the partnership anti-abuse regulation, Treas. Reg. § 1.701-2, are partnership items under I.R.C. § 6231(a).

[*] Issue 2 is not a coordinated issue. It is included as a supplement to the coordinated issue.

EXAMINATION DIVISION'S POSITION

The position of the Examination Division is that the Commissioner is authorized under Treas. Reg. § 1.701-2 to recast partnership transactions that are abusive.

DISCUSSION

Issue 1. Under what circumstances is the Commissioner of the Internal Revenue authorized under Treas. Reg. § 1.701-2 to recast a transaction involving the use of a partnership?

In response to perceived abuses achieved by structuring transactions through partnerships, the Commissioner issued Proposed Treasury Regulation § 1.701-2 on May 17, 1994. After considerable discussion, the final regulation was issued on December 29, 1994. The regulation is known as the partnership anti-abuse regulation.

Announcement 94-87, 1994-27 I.R.B. 124 was issued June 13, 1994. The announcement identified the procedures which Examination personnel were required to use if indications of abusive partnership activities were detected.

THE REGULATION

Treasury Regulation § 1.701-2 was issued based on Treasury's general power to issue regulations interpreting and applying existing law under I.R.C. § 7805.

The regulation authorizes the Commissioner to recast transactions to ensure that the income tax treatment of each partnership transaction is consistent with the intent of subchapter K.

The elements necessary for the Commissioner to recast a partnership transaction are:

> Purpose - A principal purpose is to reduce partner income tax liability.
>
> Partner tax liability - The reduction must be a substantial reduction of the aggregate income tax liability of all of the partners. Present value factors must be considered.
>
> Intent of subchapter K - the reduction in the partners' aggregate income tax liability is achieved in a manner that is inconsistent with the intent of subchapter K. The regulation provides an explanation of the intent of subchapter K.

Purpose

There are often multiple reasons for a transaction. The anti-abuse regulation asks whether one of the reasons is to reduce income tax liability and whether that is **a principal purpose**. If so, the transaction may come within the jurisdiction of the regulation. The existence of other reasons for creating a transaction does not remove the transaction from the regulation's domain, but a comparison of the purported business purpose with tax benefit may influence the determination of whether a transaction is subject to the regulation.

Partner tax liability

The reduction in tax liability must take into account the present value of the partners' aggregate federal income tax liability. The parameters for making the present value analysis are not described in the regulation.

The aggregate federal income tax of all of the partners is compared to the tax resulting from alternative methods of structuring the transaction. Facts and circumstances govern which alternative method of reporting the transaction is in line with the intent of subchapter K.

<u>Intent of subchapter K</u>

The regulation says that subchapter K "is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax." There must be a bona fide partnership, and transactions should have a substantial business purpose. Substance over form principles should apply. In most cases, the tax consequences must reflect the partners' economic agreement and clearly reflect a partner's income. Certain provisions under subchapter K, however, were adopted to promote administrative convenience (and other policy objectives) and may produce results that do not properly reflect income. Thus, an exception to the clear reflection of income standard is made for Code sections that clearly contemplate a result that is not a clear reflection of income.

<u>Suggested factors to be considered</u>

Each case is determined based on all the facts and circumstances. Some, but not all, of the factors to consider are:

1. The tax liability resulting from owning property through a partnership is substantially less than the tax liability that would have resulted if the assets were owned directly by the partners.

2. The tax liability resulting from treating the transaction as a series of steps is substantially less than the tax liability that would have resulted if the steps had been considered as one transaction.

3. Partner(s) have nominal interests, protection from loss, or preferred returns with little participation in profits.

4. There are related partners.

5 Allocations follow the literal language of Treas. Reg. §§ 1.704-1 and 1.704-2 but produce results that are inconsistent with the purpose of section 704(b) (particularly where one partner is exempt from U.S. tax).

6. The contributing partner, or a related party, retains the benefits and burdens of the ownership of property that has been contributed to the partnership.

7. Benefits and burdens of property ownership shift to a distributee partner, or a related party, before or after the actual distribution.

<u>Examples</u>

The regulation has eleven examples that apply these factors to hypothetical situations. All but three examples describe situations that may appear superficially to fall within the regulation but are not abusive.

Examples 7, 8, and 11 describe complex transactions that may be recast by the Commissioner. In each case, the suggestion is made that the anti-abuse regulation may be an appropriate additional argument to the other arguments raised under judicial principles or specific provisions of the Internal Revenue Code. Example 8's conclusion illustrates this principle.

> Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under section 707…), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

In addition to a challenge under the partnership anti-abuse regulation, examinations are expected to challenge partnership transactions based on an interpretation of the Code and regulations as well as judicial doctrines such as substance versus form, step-transactions, and clear reflection of income.

<u>Abuse of entity treatment</u>

The regulation notes that different results can be achieved when a partnership is considered to be a separate entity and when it is considered to be an aggregate of its partners. The Commissioner may treat the partnership as an aggregate of its partners in whole or in part in order to carry out the provisions of the Code and regulations, unless a specific provision prescribes treatment of the partnership as an entity and that treatment was clearly contemplated by the provision.

Three examples illustrate these rules. The first two examples are situations that the commissioner asserts will cause the partnership to be treated as an aggregate of the partners. In the first example, a partnership was used to avoid the original issue discount rules of section 163(e)(5) that apply to corporations. The second example describes a partnership that was used by corporate partners to avoid the reduction in basis required of corporations under section 1059 in the event of receipt of extraordinary dividends.

The final example illustrates a situation where the Commissioner will treat partnership as an entity. A partnership was formed to take advantage of the look-through provisions for computing foreign tax credit. By operating in this manner, the domestic corporate partner was subject to the Controlled Foreign Corporation regime described in sections 904(d)(2)(E) and 904(d)(3). The law clearly contemplated this result when it was developed.

Effective date

The regulation has two effective dates. The portions of the regulation (paragraphs (e)and (f)) that discusses the abuse of entity treatment are effective for transactions that occur on or after December 29, 1994. All other provisions are effective for transactions occurring on or after May 12, 1994.

The final regulations issued December 29, 1994, were published in the Federal Register on January 3, 1995. In Announcement 95-8, 1995-7 I.R.B. 56, issued February 13, 1995, the Service restricted the application of the anti-abuse regulations to taxes under subtitle A (income taxes) and omitted any application to transfer taxes. The announcement further provided that examples 5 and 6, dealing with transfer taxes, would be deleted. These changes would be effective as of the regulation's effective date. See T.D. 8592 (April 12, 1995).

SETTLEMENT GUIDELINES

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DISCUSSION

Issue 2. Whether the adjustments made because of the partnership anti-abuse regulation, Treas. Reg. § 1.701-2, are partnership items under I.R.C. § 6231(a).

Subject to several exceptions, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership rules of I.R.C. § 6221 through § 6233 govern the examination of partnerships. The principal exception to the TEFRA rules is the small partnership exception. If a partnership has ten or fewer partners, each of which is a natural person or estate, none of which is a nonresident alien, and each partner's share of each partnership item is the same as his share of every other item, the small partnership exception applies. [1] TEFRA partnership rules will not be followed. Most partnerships will not qualify for the small partnership exception.

Important differences in the examination procedures exist between TEFRA partnerships and partnerships not subject to TEFRA (non-TEFRA partnerships). The end result is the same. That is, there is an assessment of additional or reduced tax to the taxpayer that included the flow-through item on a taxable return. The method of accomplishing the result is different.

Significant differences include notice requirements, agreement forms, and statute extensions. In the case of proposed changes to partnership items which are not agreed, the Service must issue a Notice of Final Partnership Administrative Adjustment (FPAA) to the Tax Matters Partner and to every partner in a TEFRA partnership. A Statutory Notice of Deficiency is issued to a partner when the disputed issues are raised in a non-TEFRA partnership. An error in the selection of the type of agreement form or notice used can result in the inability of the Service to assess any tax.

Adjustments to partnership items are required to be made at the partnership level. Partnership items are defined in section 6231(a)(3) and Treas. Reg. § 301.6231(a)(3)-1. A partnership item is any item required to be taken into account for the partnership's taxable year under any provisions of subtitle A (Income Taxes) that is more appropriately determined at the partnership level than at the partner level. The regulation lists items which are clearly partnership items. For example, any adjustments to partnership ordinary income (loss) from a trade or business activity are clearly partnership items. Not all items are as well defined as the items listed in the regulation. The test the Tax Court uses is whether the factual determinations needed to decide the question can be made from the partnership records or must be made at the partner level. *Roberts v. Commissioner*, 94 T.C. 853 (1990); *N.C.F. Energy Partners v. Commissioner*, 89 T.C. 741 (1989); *Maxwell v. Commissioner*, 87 T.C. 783 (1986).

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[1] The Taxpayer Relief Act of 1997 broadened the small partnership exception for partnerships whose taxable years end after August 5, 1997. The revised section 6231(a)(1)(B)(i)(II) provides that partnerships having ten or fewer partners including C corporations may now qualify for the exception from TEFRA procedures. The revised statute also clarifies that a husband and wife are to be treated as one partner in determining whether the exception is available. Finally, the revised statute no longer contains a requirement that each partner hold the same share of the partnership.

An item need not be listed in the Code or Regulations under section 6231 in order to be considered a partnership item. *885 Investment Co. v. Commissioner*, 95 T.C. 156 (1990). One item may be considered a partnership item, while other items affected by that item are not. For example, a guaranteed payment to a partner is a partnership item, but the deductibility of expenses incurred by that partner to earn the guaranteed payment is an affected item and not a partnership item. *Woody v. Commissioner*, 95 T.C. 193 (1990).

An excellent explanation of the distinction between partnership items and affected items when "at risk" is an issue, is found in *Hambrose Leasing v. Commissioner*, 99 T.C. 15 (1992). Partnership level determinations may influence the application of I.R.C. § 465, but the ultimate decision of whether a partner is "at risk" is made at the partner level.

The anti-abuse regulation is to be applied to partnerships which are formed or availed of in connection with transactions which have a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. The purposes of a partnership and whether that purpose is a principal purpose will be determined at the partnership level.

Once the determination has been made at the partnership level, the Commissioner may recast the transaction. The regulation lists the methods which the Commission considers available:

> (1) Consider that the assets and activities of the partnership are, in whole or part, owned and conducted by one or more of the partners.
>
> (2) Treat one or more of the partners as if they were not partners.
>
> (3) Adjust the method of accounting of a partner or the partnership to clearly reflect the partnership's or partner's income.
>
> (4) Reallocate partnership items of income, gain, loss, deduction, or credit.
>
> (5) Modify or adjust the claimed tax treatment.

The adjustments described in (1), (2), and (4) are partnership level adjustments and, therefore, are potentially subject to the TEFRA rules. The adjustments described in (3) and (5) may or may not be partnership items, depending on the circumstances. For example, an adjustment described in (3) to the partnership's method of accounting is a partnership item, but an adjustment to the partner's method of accounting is an affected item. The same distinction is relevant for the adjustments described in (5), modification or adjustment of the claimed tax treatment. The nature of the transaction should be reviewed to determine whether any part of the adjustment is more properly determined at the partner level.

CONCLUSION

Adjustments made pursuant to the anti-abuse regulation to a TEFRA partnership are subject to TEFRA partnership rules. If there is an element determined at the partnership level and an element determined at the partner level, the partnership element should be raised through the TEFRA partnership proceedings, and the affected item elements should be raised at the partner level. If adjustments to a TEFRA partnership are proposed in accordance with the partnership anti-abuse regulation, but the TEFRA partnership rules are not followed, the case should be returned to the examiner.

Bibliography

The articles listed below include critical comments about the regulation:

Banoff, Sheldon I., P.C., “Anatomy of an Antiabuse Rule: What’s Really Wrong with Reg. Section 1.701-2,” 95 Tax Notes Today 56-84, (March 20, 1995)

Caudill, William H., “Ninth Circuit Invalidates Anti-abuse Rule: Is Reg. 1.701-2 Similarly Flawed?” Journal of Taxation, December 1995 pp. 380-381

Garrett, Elizabeth, “Viewpoint—Remarks on Anti-Abuse Rules,” Taxes, March 1966, pp. 197-200

Gideon, Kenneth W., “Use, Abuse, and Anti-Abuse: Policy considerations Affecting the Nature of Regulatory Guidance,” Taxes, December 1995, pp. 637-640

Lipton, Richard M., “The Partnership Anti-Abuse Regs. Revisited: Is There Calm After the Storm?” Journal of Taxation, August 1995, pp. 68-74

Marino, Herman J., “The Partnership Anti-Abuse Regulation: the Treasury Redefines the ‘Intent of subchapter K’,” Taxes, April 1995, pp. 171-182

Nelson, William F., “The Limits of Literalism: the Effect of Substance Over Form, Clear Reflection and Business Purpose Considerations On the Proper Interpretation ofSubchapter K,” Taxes, December 1995, pp. 641-658

Gideon, Kenneth W., “Wilmer, Cutler & Pickering Attorney says Partnership Antiabuse Rule Encourages ‘Standardless Challenges’ by IRS Agents,” 95 Tax Notes Today 175-26

Gibbs, Lawrence B. and Nolan, John S., “Partnership Antiabuse rule is Broader than Necessary, Says Miller & Chevalier Attorneys,” 95 Tax Notes Today 175-27

Alexander, Donald C., Goffe, William A., Gutman, Harry L., McConaghy, Mark L., Shapiro, Bernard M., Shashy, Abraham. N.M., Jr., Sterrett, Samuel B. and Williams, B. John, “Commentators Say Partnership Antiabuse Rule Doesn’t Satisfy Fundamental Principles for a Workable Tax System,: 95 Tax Notes Today 175-28

Comments in the below listed articles present counterarguments to the critical articles:

Brockway, David H., "Brockway Sees Necessity for Partnership Anti-Abuse Rule," 95 Tax Notes Today 190-24

Hyde, Terrill A., "Anti-Antiabuse Rule Rhetoric is Full of Holes," 95 Tax Notes Today 72-49

Thompson, Samuel C. Jr., "Ex-government Officials Challenge Partnership Anti-abuse Reg: An Analysis," 95 Tax Notes Today 242-47